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Kentucky Law Survey: Taxation

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Taxation

BY KATHRYN L. MOORE*

INTRODUCTION

Certainly the most publicized development in Kentucky tax law during the last five years was the series of decisions in *St. Ledger v. Kentucky Revenue Cabinet*,¹ striking down two of Kentucky's intangibles taxes.² The *St. Ledger* decisions, however, were not the only tax law development to receive attention.

There were a number of legislative developments of some significance. Specifically, Governor Brereton Jones formed a Tax Policy Commission that comprehensively reviewed Kentucky's tax structure.³ Although the 1996 General Assembly did not fully embrace the Commission's recommendations over the last five years, the General Assembly did enact some significant legislation. For example, the General Assembly enacted legislation permitting affiliated corporations to choose between filing their income tax returns on a separate or consolidated basis.⁴ In addition, it replaced Kentucky's century-old bank shares tax with a franchise-based tax.⁵ Finally,

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¹ *St. Ledger v. Kentucky Revenue Cabinet*, 912 S.W.2d 34 (Ky. 1995), *vacated and remanded*, 116 S. Ct. 1821 (1996), *on remand*, 942 S.W.2d 893 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

² For a brief discussion of the cases, see Part II.A. For a more detailed discussion of the cases, see Rick Alsip et al., Note, *St. Ledger v. Kentucky Revenue Cabinet: The Tax That Would Not Die*, 86 KY. L.J. 1053 (1997-98), in this issue.

³ See Part I.A.

⁴ See 1996 Ky. Acts ch. 239 (codified as amended at KY. REV. STAT. ANN. [hereinafter K.R.S.] § 141.120 (Michie Supp. 1996) (discussed in Part I.B)).

⁵ See 1996 Ky. Acts ch. 254 (codified as amended at K.R.S. §§ 136.500-.575 (Michie Supp. 1996) (discussed in Part I.C)).

the General Assembly enacted legislation phasing out much of the inheritance tax.⁶

On the judicial side, a number of unreported decisions also received a good deal of attention. For example, in a decision that has yet to become final, the Supreme Court of Kentucky upheld the constitutionality of the Revenue Cabinet's interim method of assessing unmined coal for tax years 1989 through 1991.⁷ In an unpublished opinion that subsequently was withdrawn, the Kentucky Court of Appeals denied a foreign holding company a remedy for unconstitutional discrimination imposed by a preferential license tax scheme.⁸

This Article discusses the legislative and judicial developments described above. In addition, it discusses a few other developments that may be of interest to tax practitioners.⁹

I. LEGISLATIVE DEVELOPMENTS

A. *Tax Policy Commission*

In February 1995, Governor Brereton C. Jones created the Kentucky Commission on Tax Policy.¹⁰ The Commission, composed of representatives from private enterprise, the General Assembly, and state government, was charged with comprehensively reviewing Kentucky's tax structure with a focus on (1) fairness, (2) simplicity, (3) adequacy, and (4) competitiveness.¹¹

On November 15, 1995, the Commission issued its final report recommending a number of significant changes in Kentucky tax law.¹² For example,

⁶ 1995 Ky. Acts ch. 2 (codified as amended at K.R.S. §§ 136.53, 140.070 & 140.080 (Michie Supp. 1996) (discussed in Part I.D)).

⁷ See *Kentucky Revenue Cabinet v. Gillig*, 1997 Ky. LEXIS 91 (decision not final) (discussed in Part II.B).

⁸ See *Kentucky Revenue Cabinet v. USX Corp.*, No. 93-CA-000072-MR and No. 93-CA-000123-MR (Ky. Ct. App. 1994), reprinted in BRUCE F. CLARK ET AL., KENTUCKY STATE TAX ISSUES UPDATE 122-30 (1995) [hereinafter 1995 UPDATE] (discussed in Part II.C).

⁹ This survey is not intended to provide an exhaustive listing of all developments in Kentucky taxation in the last five years. For more comprehensive coverage, see TERRY F. CONLEY ET AL., KENTUCKY STATE TAX ISSUES UPDATE (1997) [hereinafter 1997 UPDATE]; BRUCE F. CLARK ET AL., KENTUCKY STATE TAX ISSUES UPDATE (1996) [hereinafter 1996 UPDATE]; 1995 UPDATE, *supra* note 8.

¹⁰ See Executive Order 94-129 (Feb. 6, 1995).

¹¹ See *id.*

¹² See KENTUCKY COMMISSION ON TAX POLICY, A BLUEPRINT FOR COMPREHENSIVE REFORM (Nov. 15, 1995) [hereinafter BLUEPRINT].

the Commission proposed eliminating the preference given to Kentucky domestic corporations under the license tax¹³ and extending the sales tax to new services.¹⁴ In addition, the Commission proposed a constitutional amendment to eliminate all property taxes on tangible and intangible property.¹⁵

Although the efforts of the Commission were praiseworthy, the 1996 General Assembly followed through on few of the Commission's recommendations.¹⁶ The General Assembly's failure to embrace fully the Commission's recommendations may be attributed to a number of factors.¹⁷ First, the Commission was formed by Governor Brereton Jones, who was no longer in office when the 1996 General Assembly convened.¹⁸ Second, the General Assembly reformed inheritance¹⁹ and pension²⁰ taxation in a 1995 Special Session, so those critical areas were removed from the Commission's review.²¹ Finally, in 1996, new taxes were highly objectionable given the political environment in Kentucky, as throughout most of the nation.²² Because the Commission was charged with revenue neutrality, any reduction in taxation in one area had to be replaced with an increase in taxation in another area, and the political climate simply did not support any new taxes.²³

Despite the fact that the 1996 General Assembly did not wholly embrace the Commission's recommendations, the General Assembly did enact some noteworthy legislative changes over the last five years. Those changes are discussed below.

*B. Consolidated Income Tax Returns – House Bill 599*²⁴

Before House Bill 599, there had been extensive litigation and uncertainty regarding the proper method of filing and reporting Kentucky income

¹³ See *id.* at 5, 58.

¹⁴ See *id.* at 7-8, 64-65.

¹⁵ See *id.* at 5-6, 58-61.

¹⁶ The 1996 General Assembly did not disregard all of the Commission's recommendations. For example, the Commission recommended that the health care provider tax, as applied to physicians, be eliminated, see *id.* at 7, 62-63, and the 1996 General Assembly enacted legislation phasing out the provider tax as applied to physicians, see *infra* Part I.F.

¹⁷ See 1996 UPDATE, *supra* note 9, at 1-2.

¹⁸ See *id.* at 1.

¹⁹ See *infra* Part I.D.

²⁰ See *infra* Part I.I.

²¹ See BLUEPRINT, *supra* note 12, at 1.

²² See *id.*

²³ See *id.* at 1-2.

²⁴ 1996 Ky. Acts ch. 239.

tax for multi-corporate groups.²⁵ In 1972, the Kentucky Revenue Cabinet began to rely on section 141.120 as authority for the filing of combined income tax returns for unitary multi-corporate businesses.²⁶ Under the unitary combined reporting method, each member of a "unitary business computes its individual taxable income by taking a portion of the combined net income of the group."²⁷ This method of tax accounting is designed to "insure that the income of a business that is conducted partly within and partly without a taxing state is determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or two or more affiliated corporations."²⁸

Traditionally,²⁹ a three-unities test was used to determine whether a multi-corporate group constituted a unitary business.³⁰ Under that test, a business is unitary if there is "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use of its centralized executive force and general system of operation."³¹ The test had to be applied on a taxpayer-specific basis

²⁵ See 1996 UPDATE, *supra* note 9, at 11.

²⁶ See *G.T.E. v. Kentucky Revenue Cabinet*, 889 S.W.2d 788, 790 (Ky. 1994).

²⁷ *Caterpillar Tractor Co. v. Department of Revenue*, 618 P.2d 1261, 1262-63 (Or. 1980); see also *Income Taxes: Consolidated Returns and Combined Reporting Tax Management*, MULTISTATE TAX PORTFOLIOS 1130:0002 (1994); Frank M. Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975).

²⁸ Keesling, *supra* note 27, at 106.

²⁹ In 1995, the Kentucky Revenue Cabinet proposed a regulation, which, among other things, would have adopted the three criteria of functional integration, centralization of management, and economies of scale to determine when a business is unitary. See proposed 103 K.A.R. 16:190(1)(26), in 4 K.A.R. 761 (Oct. 1, 1995). These three criteria were emphasized by the United States Supreme Court in *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982), and *F.W. Woolworth v. Taxation and Revenue Dep't*, 458 U.S. 354 (1982). Following numerous hearings and a great deal of comment by the tax bar and private industry, the Revenue Cabinet withdrew the regulation. See 22 K.A.R. E3 (Nov. 1, 1995).

³⁰ See, e.g., *G.T.E. v. Kentucky Revenue Cabinet*, 889 S.W.2d 788, 789 (Ky. 1988); *Armco, Inc. v. Kentucky Revenue Cabinet*, 748 S.W.2d 372, 375 (Ky. 1988).

³¹ *Butler Bros. v. McColgan*, 111 P.2d 334, 341 (Cal. 1941), *aff'd*, 315 U.S. 501 (1942).

"[T]he unitary business concept is . . . not, so to speak, unitary: there are variations on the theme." *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 167 (1983). For an extensive discussion of alternative methods to determine whether a multi-corporate group constitutes a unitary business, see, for example, 1110 Tax

and required a specific factual determination as to whether a particular taxpayer constituted a unitary business.³²

In two reported decisions in the 1980s, *Armco, Inc. v. Kentucky Revenue Cabinet* and *Kentucky Department of Revenue v. The Early & Daniel Co.*,³³ the Kentucky Supreme Court upheld the Revenue Cabinet's requirement that a multi-corporate group that constituted a unitary business file a combined income tax return. In both of these cases, the unitary group included a domestic international sales corporation ("DISC").³⁴ The DISCs owned no property, retained no employees other than their officers and directors, and made no sales themselves.³⁵ Following these cases, the Revenue Cabinet issued Revenue Policy 41P225 interpreting the cases³⁶ as limiting combined income tax reporting to unitary groups that include sham or paper corporations.

Management Multistate Tax Portfolios: Income Taxes: Definition of a Unitary Business (1996); JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, I STATE TAXATION: CORPORATION INCOME AND FRANCHISE TAXES ¶ 8.11 (2d ed. 1993).

For additional discussions of the unitary business concept, see, for example, Charles E. McLure, Jr., *Defining a Unitary Business: An Economist's View*, reprinted in ECONOMIC PERSPECTIVES ON STATE TAXATION OF MULTIJURISDICTIONAL CORPORATIONS 47 (1986); E. George Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970); Frank M. Kessler & John S. Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42 (1960).

³² See 1996 UPDATE, *supra* note 9, at 2.

³³ *Armco, Inc. v. Kentucky Revenue Cabinet*, 748 S.W.2d 372 (Ky. 1988); *Kentucky Dep't of Revenue v. The Early & Daniel Co.*, 628 S.W.2d 630 (Ky. 1982).

³⁴ A DISC was a corporate entity given special federal income tax treatment to encourage exports by U.S. firms. See 26 U.S.C. §§ 991-997. For a discussion of the reasons for the DISC preferential tax treatment, see H. Rep. No. 533 (1971), reprinted in 1971 U.S.C.C.A.N. 1825, 1872; S. Rep. No. 437 (1971), reprinted in 1971 U.S.C.C.A.N. 1918, 1928, 1996. In 1984 Congress generally repealed the DISC system of tax deferrals and replaced it with the less favorable foreign sales corporation system of taxation. See 26 U.S.C. 921-927.

³⁵ See *Armco, Inc.*, 748 S.W.2d at 375; *Early & Daniel Co.*, 628 S.W.2d at 631.

³⁶ The Revenue Cabinet also relied on similar decisions by the Kentucky Board of Tax Appeals and an unreported decision by the Kentucky Supreme Court, *V.E. Anderson v. Kentucky Revenue Cabinet*, 87-SC-122-DG (Ky. Nov. 5, 1987) (citing Revenue Policy 41P225). See *G.T.E. v. Kentucky Revenue Cabinet*, 889 S.W.2d 788, 790-91 (Ky. 1994) (discussing *V.E. Anderson*).

In *G.T.E. v. Kentucky Revenue Cabinet*,³⁷ the Kentucky Supreme Court struck down Revenue Policy 41P225 and held that a multi-corporate group that constituted a unitary business had the right to file a combined income tax return even if the group did not contain any sham or paper corporations. Following this decision, the Kentucky Revenue Cabinet proposed a regulation, 103 KAR 16:190, that would have mandated combined reporting for broadly defined unitary groups.³⁸ The proposed regulation engendered so much opposition from the Kentucky corporate community³⁹ that the Revenue Cabinet withdrew the regulation.⁴⁰

The Revenue Cabinet and the Kentucky business community then worked together for a legislative compromise.⁴¹ That compromise, contained in House Bill 599,⁴² permits affiliated corporations to choose between filing their income tax returns on a separate or consolidated basis, while prohibiting them from changing that basis from year to year depending on which is more advantageous in a particular year.⁴³ Thus, effective for tax years beginning on or after December 31, 1995, House Bill 599 amended sections 141.120 and 141.200 to allow members of an affiliated group to elect to file a consolidated Kentucky income tax return regardless of whether the group filed a consolidated federal income tax return.⁴⁴ If an election is made to file a consolidated return, the statute requires that the election remain in force for an eight-year period.⁴⁵

The statute should eliminate much of the uncertainty in the corporate income tax area by replacing combined reporting with the option of filing

³⁷ *G.T.E. v. Kentucky Revenue Cabinet*, 889 S.W.2d 788 (Ky. 1994).

³⁸ See *supra* note 6.

³⁹ For a brief summary of that criticism, see Kendall L. Houghton, *Kentucky Revenue Cabinet Gets Negative Feedback on Proposed Combined Reporting Reg.*, 95 STN 144-12 (July 27, 1995) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES). For the text of the amended proposed regulation and excerpts from comments and responses to those comments, see *Kentucky Revenue Cabinet Amends Corporation Income Tax Reg.*, 95 STN 200-10 (Oct. 17, 1995) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES).

⁴⁰ See *Kentucky Revenue Cabinet Withdraws Proposed Reg. Concerning Combined Reporting Method for Corporation Income Tax Purposes*, 9 STATE TAX NOTES 1308 (Nov. 6, 1995) [hereinafter *Cabinet Withdraws Proposed Reg.*].

⁴¹ See Laurel C. Farrell, *The State of Combined Reporting Today*, 96 STN 167-24 (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES).

⁴² See *id.*

⁴³ See *Cabinet Withdraws Proposed Reg.*, *supra* note 40.

⁴⁴ See K.R.S. § 141.200(3)(a) (Michie Supp. 1996).

⁴⁵ See *id.* § 141.200(3)(d).

consolidated income tax returns.⁴⁶ As noted above, combined reporting applies to unitary businesses, and determining whether a multi-corporate group constitutes a unitary business requires an intense factual determination that must be applied on a taxpayer-specific basis.⁴⁷ Consolidated income tax returns, in contrast, may be filed by "affiliated groups," and affiliated groups are determined simply by applying clear and well-established common ownership rules.⁴⁸

The statute does not, however, eliminate all uncertainty. For example, it does not apply to tax years beginning on or before December 31, 1995. Moreover, it does not address issues such as net operating losses, capital gains, and contributions made by members of the consolidated group.⁴⁹

*C. Bank Franchise and Local Deposit Tax Act – House Bill 416*⁵⁰

Effective July 15, 1996, House Bill 416 repealed Kentucky's century-old bank shares tax⁵¹ and replaced it with a franchise-based tax.⁵² The franchise tax is imposed on every financial institution regularly engaged in business in the Commonwealth at any time during the taxable year.⁵³ Generally, an institution is presumed to be regularly engaged in business in the Commonwealth if it solicits business from twenty or more persons in the state or it has

⁴⁶ See *id.* § 141.120(11) ("Nothing in this section shall be construed as allowing or requiring the filing of a combined return under the unitary business concept or a consolidated return."). Nevertheless, the Revenue Cabinet may maintain that *Armco, Inc. v. Kentucky Revenue Cabinet*, 748 S.W.2d 372 (Ky. 1988), and *Department of Revenue v. The Early & Daniel Co.*, 628 S.W.2d 630 (Ky. 1982), provide it with the discretionary authority to require unitary combined reports. See *KPMG Survey Probes State, Local Business Incentives*, 95 STN 222-46 (November 17, 1995) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES).

⁴⁷ See *supra* notes 29-32 and accompanying text.

⁴⁸ See K.R.S. § 141.200(1)(a) (defining affiliated groups with reference to section 1504(a) of the Internal Revenue Code and related regulations).

⁴⁹ See 1995 UPDATE, *supra* note 9, at 10.

⁵⁰ 1996 Ky. Acts ch. 254.

⁵¹ See K.R.S. § 136.270 (Michie. Supp. 1996), repealed by 1996 Ky. Acts ch. 254, § 39, effective July 15, 1996.

⁵² The provision applies retroactively to January 1, 1996, for financial institutions doing business in Kentucky on the effective date of the legislation. See Mark F. Sommer, *Bank Tax Rewrite Becomes Law After Lobbying Blitz*, 12 STATE TAX NOTES 1357, 1358 (May 6, 1996).

⁵³ See K.R.S. § 136.505(1).

receipts from Kentucky sources of \$100,000 or more during a taxable year.⁵⁴ The franchise tax is imposed at the rate of 1.1% of net capital (after apportionment if the institution does business both within and outside the state),⁵⁵ with a minimum tax payable of \$300 per year.⁵⁶

Net capital is determined over a five-year period by adding together paid-in capital, surplus, undivided profits and capital reserves, net unrealized gains or losses on certain securities, and cumulative foreign currency translation adjustments, and then deducting from the total an amount equal to the same percentage of the total as the book value of United States obligations bears to the book value of the total assets of the financial institution.⁵⁷ Net capital includes equity related to investment in subsidiaries.⁵⁸

The franchise tax is assessed in lieu of all other city, county, and local taxes, except the real estate transfer tax, real and tangible personal property taxes, utilities taxes, and local deposit franchise taxes.⁵⁹ A "little-noticed"⁶⁰ provision authorizes cities, counties, and urban-county governments to impose a tax on any bank having a branch located within the jurisdiction's limits.⁶¹ The rate imposed by cities and counties may not exceed .025% of the deposits held by the financial institutions located within their jurisdiction, while the rate imposed by urban-county governments may not exceed .050% of deposits.⁶² As of early 1997, only a few Kentucky municipalities had enacted the tax, but numerous others were either considering it or taking steps to implement it.⁶³

⁵⁴ See *id.* § 136.520(1). Receipts from interests in certain types of property, such as real estate mortgage investment conduits and real investment trusts, are excluded in determining whether an institution is regularly engaged in business in Kentucky. See *id.*

⁵⁵ See *id.* §§ 136.525-.540.

⁵⁶ See *id.* § 136.510.

⁵⁷ See *id.* § 136.515.

⁵⁸ See *id.* § 136.515(2)(b).

⁵⁹ See *id.* § 136.505(2).

⁶⁰ Mark F. Sommer, *Cities Move to Adopt Local Bank Taxes*, 12 STATE TAX NOTES 578 (Feb. 24, 1997).

⁶¹ See K.R.S. § 136.575.

⁶² See *id.* § 136.575(2).

⁶³ See Sommer, *supra* note 52, at 578. Although the local deposits franchise tax was intended to replace the Kentucky bank share tax, the new tax may be imposed by local governments that did not formerly levy the bank shares tax. Conversely, local jurisdictions that imposed the bank shares tax may elect not to impose the franchise tax, or impose a different tax rate, so long as the maximum rate is not

A “potentially troublesome”⁶⁴ provision of the Act⁶⁵ may prohibit financial institutions from seeking to enforce security interests or collect on loans in Kentucky courts until the financial institutions pay franchise taxes and file appropriate franchise tax returns:

Any financial institution subject to the annual franchise tax imposed by KRS 136.505 that fails to file a return as required by KRS 135.545 or that fails to pay the tax as listed on the return shall not maintain an action, suit, or proceeding in any court or before any agency in this Commonwealth or enforce in any way any obligation of any debts until the return is filed and the tax listed on the return is paid.⁶⁶

As noted above, the Act sets forth extremely broad nexus standards. It subjects “[e]very financial institution regularly engaged in business”⁶⁷ in the Commonwealth to the franchise tax and presumes that an institution is regularly engaged in business in the Commonwealth if it solicits business from twenty or more persons in the state or has receipts from Kentucky sources of \$100,000 or more during a taxable year.⁶⁸ Thus, under the Act, a financial institution located in Miami, Florida, that simply mails credit card applications to twenty Kentucky residents is presumed to be regularly engaged in business in the state even though it has no physical presence in the state.

Although the Act provides that its nexus provision is to “be interpreted to reach to the limits permitted by the United States Constitution,”⁶⁹ it may in fact exceed federal constitutional limits. In *Quill Corp. v. North Dakota*,⁷⁰ the United States Supreme Court held that the Commerce Clause requires that an out-of-state seller have *some* physical presence in the state before the state can impose use tax collection responsibilities on that seller.⁷¹ If *Quill*’s physical-presence standard applies to the franchise tax,

exceeded. See *Local Deposits Franchise Tax Provisions Clarified*, 57 State Tax Review (CCH) 11 (Nov. 4, 1996) (citing Kentucky Tax Alert, Kentucky Revenue Cabinet (Sept. 1996)).

⁶⁴ Mark F. Sommer, *Bank Franchise Tax Act Contains Tough Enforcement Provision*, 11 STATE TAX NOTES 1428 (Nov. 18, 1996).

⁶⁵ See K.R.S. § 136.570(2).

⁶⁶ *Id.*

⁶⁷ *Id.* § 136.505(1).

⁶⁸ See *id.* § 136.520(1).

⁶⁹ *Id.* § 136.520(2).

⁷⁰ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁷¹ See *id.* at 314-19.

then the Act's nexus provision clearly violates the United States Constitution.

Whether *Quill*'s physical-presence requirement applies to the Kentucky bank franchise tax, however, is not entirely clear. *Quill* left open the question whether its physical-presence standard applies to taxes other than sales and use taxes.⁷² The Court noted that it had not, "in [its] review of other types of taxes, articulated the same physical-presence requirement."⁷³

Thus, opinion as to *Quill*'s reach has been divided. In *Geoffrey, Inc. v. South Carolina Tax Commission*,⁷⁴ the South Carolina Supreme Court held that the state could tax the income of a corporation that had no physical presence in the state where the income was derived from intangible property owned by the corporation and used within the state.⁷⁵ In contrast,

⁷² See Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property, and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 407 (1994) ("*Quill* left unanswered whether a state can tax the income of a corporation which is not physically present in the state where the income is derived from intangible property owned by the corporation and used within the state."); JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, II STATE TAXATION: SALES AND USE, PERSONAL, INCOME, AND DEATH AND GIFT TAXES ¶ 6.08[1], at S6-6 (1996/1997 Supp.) [hereinafter HELLERSTEIN & HELLERSTEIN, STATE TAXATION] ("A major unresolved question left unanswered by the Supreme Court's holding in *Quill Corp. v. North Dakota* is whether the physical presence requirement of the vendor in the State as a sine qua non of the State's constitutional power to require the vendor to collect its use tax on sales of property delivered to the purchaser in the State applies to other taxes, particularly to corporate franchise and income taxes.").

For more detailed discussions of the *Quill* decision, see, for example, Anna M. Hoti, Comment, *Finishing What Quill Started: The Transactional Nexus Test for State Use Tax Collection*, 59 ALBANY L. REV. 1449 (1996); Kathryn L. Moore, *State and Local Taxation of Interstate and Foreign Commerce: The Second Best Solution*, 42 WAYNE L. REV. 1425, 1445-50 (1996); David F. Shores, *State Taxation of Interstate Commerce: Quill, Allied Signal, and a Proposal*, 72 NEB. L. REV. 682 (1993); Pamela M. Krill, Note, *Quill Corp. v. North Dakota: Tax Nexus Under the Due Process and Commerce Clauses No Longer the Same*, 1993 WISC. L. REV. 1405 (1993).

⁷³ *Quill*, 504 U.S. at 314.

⁷⁴ *Geoffrey, Inc. v. Tax Comm'n*, 437 S.E.2d 13 (S.C.), cert. denied, 510 U.S. 992 (1993).

⁷⁵ See *id.* at 23-24. Even if a Kentucky court were to follow *Geoffrey*, it appears that a foreign corporation with only intangible property in the state would not have to pay Kentucky income tax. Every corporation with property located in the state is subject to state income tax. See K.R.S. § 141.040 (Michie 1991 & Supp. 1996).

*Cerro Copper Products, Inc. v. Department of Revenue*⁷⁶ rejected *Geoffrey's* Commerce Clause analysis and held that the Commerce Clause requires that before the state can impose income tax on a corporation, it must have a physical presence in the state. Similarly, commentators have disagreed as to whether the *Quill's* physical-presence requirement should extend to other taxes.⁷⁷ Thus, the constitutionality of the bank franchise tax's nexus provision is in doubt.

*D. Inheritance Tax – House Bill 2*⁷⁸

Before January 1995, Kentucky's inheritance tax⁷⁹ was one of the most burdensome taxes imposed by the state.⁸⁰ The tax applied to estates valued at less than \$600,000 even though most states and the federal government did not impose taxes on such estates.⁸¹ In January 1995, the Kentucky General Assembly enacted House Bill 2, which phased out the inheritance

The state, however, is allocated only real and tangible personal property located in the state. *Id.* § 141.120(8)(a) (Supp. 1996). Thus, even if the state had the nexus to tax the foreign corporation with intangibles in the state, no income would be allocated to the state through the state's allocation formula.

⁷⁶ Docket No. F. 94-444, Final Order (Dec. 11, 1995), reprinted in 95 STN 242-1 (Dec. 18, 1995) (LEXIS, Fedtax Library, STN File) (daily online version of STATE TAX NOTES).

⁷⁷ Compare *Fatale*, *supra* note 72 (supporting *Geoffrey* decision) with Richard L. Lieberman & Stewart Lipeles, *The Geoffrey Case: A Failed Attempt to Provide Content to the Economic Nexus Principle*, 65 STATE TAX NOTES 13 (Mar. 14, 1994) (criticizing *Geoffrey*). Indeed, the leading father-son team in state and local taxation, Jerome R. Hellerstein and Walter Hellerstein, disagree as to whether *Quill's* physical-presence requirement should apply to income taxes. Compare Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 STATE TAX NOTES 671 (Feb. 13, 1995) (supporting *Geoffrey*) with Walter Hellerstein, *State and Local Taxation of Intangibles Generates Increasing Controversy*, 80 J. TAX'N 296 (1994) (criticizing *Geoffrey*).

⁷⁸ 1995 Ky. Acts ch. 2 (codified as amended at K.R.S. §§ 140.070 - .080 (Michie 1995)).

⁷⁹ See K.R.S. §§ 140.010 - .120 (Michie 1995).

⁸⁰ See generally John S. Lueken, *Kentucky Inheritance Tax Update*, in 1997 UPDATE, *supra* note 9, at V1; see also CCH Tax Day: State, Mar. 9, 1995, available in Westlaw S95-068-012 (then-Kentucky Governor Brereton C. Jones noted that Kentucky's inheritance tax is highest state inheritance tax in the country).

⁸¹ See Lueken, *supra* note 80, at V1.

tax as applied to "Class A" beneficiaries over a number of years ending on July 1, 1998.⁸²

Class A beneficiaries include any

parent, surviving spouse, child by blood, stepchild, child adopted during infancy, child adopted during adulthood who was reared by the decedent during infancy or a grandchild who is the issue of a child by blood, the issue of a stepchild, the issue of a child adopted during adulthood who was reared by the decedent during infancy, the issue of a child adopted during infancy, brother sister, or brother or sister of the half blood.⁸³

For beneficiaries of decedents dying after June 30, 1998, no Kentucky inheritance tax is imposed on inheritable interests passing to Class A beneficiaries.⁸⁴

The Kentucky inheritance tax, however, remains in effect for Class B and Class C beneficiaries.⁸⁵ Class B beneficiaries include any "nephew, niece, or a nephew or niece of the half blood, daughter-in-law, son-in-law, aunt or uncle, or a great-grandchild who is the grandchild of a child by blood, of a stepchild or of a child adopted during infancy."⁸⁶ The first \$1000 received by a Class B beneficiary is exempt from tax.⁸⁷ After that, an inheritance tax ranging from four percent on inheritable assets valued at no more than \$10,000 to sixteen percent on inheritable assets valued at more than \$200,000 is imposed on inheritances by Class B beneficiaries.⁸⁸

Class C beneficiaries include any educational, religious, or other institutions, societies, or associations; any cities, towns, or public

⁸² 1995 Ky. Acts ch. 2 (codified in K.R.S. §§ 140.070 and 140.080 (Michie Supp. 1996)).

⁸³ K.R.S. § 140.070(1) (Michie Supp. 1996). House Bill 2 amended section 140.070 to expand Class A beneficiaries to include brothers, sisters, and brothers and sisters of the half blood. Before House Bill 2, brothers, sisters, and brothers and sisters of the half blood qualified as Class B beneficiaries.

⁸⁴ See *id.* § 140.080(1)(c)(4).

⁸⁵ Unlike the federal estate tax, which is a tax imposed on the estate's right to transfer wealth to designated beneficiaries, the Kentucky inheritance tax is a tax on the right to receive assets and is imposed on the value of property passing to individual beneficiaries. See Lueken, *supra* note 80, at V-2.

⁸⁶ K.R.S. § 140.070(2). Before House Bill 2, brothers, sisters, and brothers and sisters of the half blood qualified as Class B beneficiaries.

⁸⁷ See *id.* § 140.090(1)(d).

⁸⁸ See *id.* § 140.070(2).

institutions not exempted by section 140.060;⁸⁹ or any person not included in Class A or Class B.⁹⁰ The first \$500 received by a Class C beneficiary is exempt from tax.⁹¹ After that, an inheritance tax ranging from six percent on inheritable assets valued at no more than \$10,000 to sixteen percent on inheritable assets valued at more than \$60,000 is imposed on inheritances by Class C beneficiaries.⁹²

*E. Use Tax Nexus – House Bill 617*⁹³

As noted above,⁹⁴ in *Quill* the United States Supreme Court held that the Commerce Clause requires that an out-of-state seller have some physical presence in the state before the state can impose use tax collection responsibility on that seller. Although it described the physical-presence requirement as a “bright-line rule,”⁹⁵ the Court never precisely defined the physical presence necessary to satisfy the Commerce Clause substantial nexus requirement.⁹⁶

⁸⁹ *Id.* § 140.060 (Michie 1991). This section provides:

All transfers to educational, religious or other institutions, societies, or associations, whose sole object and purpose are to carry on charitable, educational, or religious work, all transfers for or upon trust for any charitable, educational, or religious purpose, and all transfers to cities, and towns or public institutions in this state for public purposes shall be exempt from the tax imposed by this chapter

Id.

⁹⁰ *See id.* § 140.070(3) (Michie Supp. 1996).

⁹¹ *See id.* § 140.090(1)(e) (Michie 1991).

⁹² *See id.* § 140.070(3) (Michie Supp. 1996).

⁹³ 1996 Ky. Acts ch. 215 (codified as amended at K.R.S. § 139.340).

⁹⁴ *See supra* notes 70-71 and accompanying text.

⁹⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298, 314-19 (1992).

⁹⁶ *See id.* at 315 n.8 (concluding that *Quill*’s licensing of software in the state failed to constitute a “substantial nexus” but declining to define what contacts would in fact constitute “substantial nexus”); *see also* Laura A. Kulwicki, *Continuing State Trends in Nexus Enforcement after Quill: The Struggle To Define “Substantial Nexus,”* 6 STATE TAX NOTES 345, 345 (Feb. 7, 1994) (“[T]his ‘bright line’ is not quite as bright as it first seems.”); *Direct Marketing Association Official Speaks on the Quill Victory at Tax Administrators’ Meeting*, 92 STN 125-22 (June 29, 1992) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES) (noting that although the *Bellas Hess* physical-presence test was called a “bright line” test, this is a relative term).

Accordingly, states and courts have since struggled with the parameters of the physical-presence requirement.⁹⁷

On December 20, 1995, the Multistate Tax Commission, working with twenty-five states and the District of Columbia,⁹⁸ issued National Nexus Program Bulletin 95-1⁹⁹ to provide some content to the standard.¹⁰⁰ The bulletin provides that an out-of-state computer vendor generally has nexus with the market state for purposes of both sales and use tax collection and income tax if the vendor contracts with a third party to provide buyers with repair services for their computers under the vendor's warranty.¹⁰¹

⁹⁷ See Kulwicki, *supra* note 96, at 346-47 (discussing then-pending litigation regarding the meaning of the substantial nexus requirement); Kim Marshall & Marc Lewis, *What We Know Today About Substantial Nexus*, 13 STATE TAX NOTES 967 (Oct. 13, 1997) (discussing current state legislation and case law on *Quill*'s substantial nexus requirement); see also *Quill*, 504 U.S. at 330-31 (White, J., dissenting) ("[I]t is a sure bet that the vagaries of 'physical presence' will be tested to their fullest in our courts."); Charles Rothfeld, *Quill: Confusing the Commerce Clause*, 3 STATE TAX NOTES 111, 111 (July 27, 1992) (stating that taxpayers and taxing officials will not be able to determine adequacy of physical presence because it is not based on clear principle). Compare Michael C. Hamersley, Note, *Will the Bellas Hess Physical Presence Requirement Continue to Protect Out-of-State Mail-Order Retailers from State Use Taxes in the Quill Era?* *Quill Corp. v. North Dakota*, 46 TAX LAW. 515, 521-23 (1993) (contending that *Quill* requires "substantial physical presence"); with Alice J. Davis, *How Much Is Too Little? Defining De Minimis Substantial Nexus*, 7 STATE TAX NOTES 1983, 1985-86 (Dec. 26, 1994) (criticizing recent New York decisions that relied on Hamersley's Note in finding that *Quill*'s nexus requirement demands "substantial physical presence").

⁹⁸ Kentucky was not one of those states, as it is not a member of the Multistate Tax Commission.

⁹⁹ NB 95-1 (Dec. 20, 1995), *Computer Company's Provision of In-State Repair Services Creates Nexus*, 95 STN 246-71 (Dec. 22, 1995) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES).

¹⁰⁰ The Multistate Tax Commission views the Bulletin as "an authoritative description of the audit position of the signatory states regarding companies engaged in the cross-border sale of computers." Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177, 177 (1996).

¹⁰¹ The bulletin is simply a refinement of the Multi-State Tax Commission's "long-standing position that a mail-order seller has nexus with a state and may be required by a state to collect the use tax if it has a service representative in that state who regularly acts on its behalf." *Id.*

Although MTC Bulletin 95-1 has been controversial,¹⁰² and one of the original twenty-five states supporting the bulletin, California, has since withdrawn its support,¹⁰³ Kentucky adopted MTC Bulletin 95-1's nexus standards for use tax purposes in House Bill 617.¹⁰⁴ Effective July 15, 1996, House Bill 617 amended section 139.340 of the Kentucky Revised Statutes to extend use tax collection responsibilities to retailers soliciting orders for tangible personal property from residents of the state "if the retailer benefits from an agent operating in this state under the authority of the retailer to repair or service tangible personal property sold by the retailer."¹⁰⁵

F. Health Care Provider Taxes – House Bill 1¹⁰⁶ and House Bill 397¹⁰⁷

In 1993, the Kentucky General Assembly enacted House Bill 1,¹⁰⁸ which imposed health care provider taxes on various health care groups.¹⁰⁹ First, it imposed on hospitals a 2.5% tax on gross revenues for the provision of health care items or services or hospital services.¹¹⁰ Second, it imposed a 2% provider tax on gross revenues for the provision of nursing facility services, intermediate care facility services for the mentally

¹⁰² See, e.g., *id.* (defending bulletin and discussing some of the criticism); Richard A. Hanson, *95-1 Defenders Take Note: Quill Court Made Its Case*, 11 STATE TAX NOTES 431 (Aug. 5, 1996) (criticizing Pomp and McIntyre article); Eric J. Miethke, *Man the Pumps! A Response to Pomp and McIntyre's Analysis of Bulletin 95-1*, 11 STATE TAX NOTES 307 (July 15, 1996) (same); Michael J. McIntyre & Richard D. Pomp, *Letter to Editor: Quill's Novelty was Tax Nexus Bifurcation*, 11 STATE TAX NOTES 588 (Aug. 19, 1996) (responding to Hanson critique); Richard D. Pomp & Michael J. McIntyre, *Adrift Without a Rudder – A Response to Seaman Miethke*, 96 STN 157-44 (Aug. 13, 1996) (LEXIS, Fedtax Library, STN File) (daily on-line version of STATE TAX NOTES) (responding to Miethke criticism).

¹⁰³ See Marshall & Lewis, *supra* note 97.

¹⁰⁴ Enact. Acts 1996, ch. 215, § 1 (codified in K.R.S. § 139.340 (Michie Supp. 1996)).

¹⁰⁵ K.R.S. § 130.340(2)(e).

¹⁰⁶ 1993 Ky. Acts ch. 2, now repealed; see *infra* note 109.

¹⁰⁷ 1996 Ky. Acts ch. 110 (codified at K.R.S. § 142.309).

¹⁰⁸ 1993 Ky. Acts ch. 2, now repealed; see *infra* note 109.

¹⁰⁹ See K.R.S. §§ 142.201-259, 216.270-287, repealed and replaced with K.R.S. §§ 142.301-359, 216.2901-2960; see also *Assembly Enacts Tax on Health Care Providers*, 5 STATE TAX NOTES 73 (July 12, 1993).

¹¹⁰ See 1993 Ky. Acts ch. 2, § 2.

retarded, physician services, home health care services, and health maintenance organization services.¹¹¹ Finally, it imposed a tax of \$0.25 per prescription on pharmacies.¹¹²

In 1994, the Kentucky General Assembly repealed and replaced the health care provider taxes imposed in House Bill 1¹¹³ with a new set of health care provider taxes under House Bill 250.¹¹⁴ The health care provider taxes under House Bill 250 are substantially similar to those under House Bill 1, with one exception. House Bill 1 permitted pharmacies to pass the \$0.25 per prescription tax on to insurers, health maintenance organizations, and non-profit hospital, medical-surgical, dental, and health service corporations, but did not permit the latter groups to pass on the tax.¹¹⁵ House Bill 250, in contrast, does not permit pharmacies to pass the prescription tax on to third-party payers.¹¹⁶

Shortly after the provider taxes were enacted, physicians filed suit claiming that the 2% provider tax impermissibly singled them out in violation of section 59(15) of the Kentucky Constitution.¹¹⁷ Although the Kentucky Supreme Court upheld the tax against the physicians' challenge in *Kentucky Revenue Cabinet v. Smith*,¹¹⁸ the General Assembly was receptive to the physicians' complaints. In 1996, it enacted House Bill 397,¹¹⁹ which phases out the 2% provider tax (as applied to physicians) over a four-year period.¹²⁰ The amendment does not affect the 2.5% provider tax on hospital services,¹²¹ the 2% tax on other providers of health care services,¹²² or the \$0.25 per prescription tax on prescription drugs.¹²³

¹¹¹ See H.B. 1 (1993), Enact. Acts 1993, ch. 2, § 3 (2d Ex. Sess.), now repealed; *supra* note 109.

¹¹² See H.B. 1, 1993 Ky. Acts ch. 2, § 4.

¹¹³ See 1994 Ky. Acts ch. 512, § 119 (repealing scattered sections of K.R.S. ch. 142).

¹¹⁴ See *id.* §§ 97-101 (amending scattered sections of K.R.S. ch. 142).

¹¹⁵ See H.R. 1, 1993 Ky. Acts ch. 2, § 4, now repealed; see *supra* note 109.

¹¹⁶ See 1994 Ky. Acts ch. 512, § 99.

¹¹⁷ See Mark F. Sommer, *Physicians Group Sues Over Health Care Provider Tax*, 5 STATE TAX NOTES 185 (July 26, 1993).

¹¹⁸ *Kentucky Revenue Cabinet v. Smith*, 875 S.W.2d 873 (Ky.), *cert. denied sub nom. Yeoman v. Kentucky Revenue Cabinet*, 513 U.S. 1000 (1994).

¹¹⁹ Enact. Acts 1996, ch. 110, § 2 (codified at K.R.S. § 142.309 (Michie Supp. 1996)).

¹²⁰ See K.R.S. § 142.309.

¹²¹ See *id.* § 142.303.

¹²² See *id.* § 142.307.

¹²³ See *id.* § 142.311.

*G. Unmined Minerals – House Bill 84*¹²⁴

In 1976, the Kentucky General Assembly enacted a statute classifying unmined coal separately from other real estate.¹²⁵ Two years later, the General Assembly enacted a statute taxing unmined coal at the rate of one-tenth of one cent (\$.001) per one hundred dollars (\$100) of assessed value.¹²⁶ In *Gillis v. Yount*,¹²⁷ the Kentucky Supreme Court held that classifying unmined coal separately from other unmined minerals violated section 171 of the Kentucky Constitution.¹²⁸

In 1994, the Kentucky General Assembly enacted House Bill 84, which requires that the Revenue Cabinet value and assess unmined coal, oil, and gas reserves that have been severed from the surface estate at no more than fair market value in place, considering all relevant circumstances.¹²⁹ The Act further provides that unmined coal, oil, and gas reserves, as well as other mineral or energy sources, are to be valued and assessed as separate interests in real property, distinct from the surface estate.¹³⁰

*H. Repair, Replacement, or Spare Parts – House Bill 455*¹³¹

Section 139.480 of the Kentucky Revised Statutes exempts from sales and use taxes purchases of machinery for new and expanded industry.¹³² To qualify for this exemption, the machinery or equipment must be used directly in the manufacturing or production process, and either must not replace machinery or must replace machinery that will increase the consumption of recycled materials at a facility by not less than ten percent.¹³³ In *Kentucky Revenue Cabinet v. Armco*,

¹²⁴ Enact. Acts 1994, ch. 263 (codified at K.R.S. § 132.820 and codified as amended at K.R.S. § 132.010).

¹²⁵ See 1976 Ky. Acts ch. 84, § 7.

¹²⁶ See K.R.S. § 132.020(5).

¹²⁷ *Gillis v. Yount*, 748 S.W.2d 357 (Ky. 1988).

¹²⁸ The majority did not reach the issue of whether the one mil tax also violated section 171 of the Kentucky Constitution. *See id.* at 358.

¹²⁹ See K.R.S. § 132.820(1).

¹³⁰ *See id.*

¹³¹ Enact. Acts. 1994, ch. 501 (codified at K.R.S. §§ 139.170 and .470).

¹³² See K.R.S. § 139.480(10).

¹³³ *See id.* § 139.170(1). The regulations provide that four specific requirements be met for machinery to qualify for the exemption:

(1) It must be machinery.

Inc.,¹³⁴ the Kentucky Court of Appeals held that a spare part that the vendor required the manufacturer to purchase with the original machinery was exempt machinery for new and expanded industry.¹³⁵ The court also held that ball bearings Armco used were exempt industrial supplies.¹³⁶

In 1994, the Kentucky General Assembly overruled *Armco, Inc.* by enacting House Bill 455, which amends section 139.170 of the Kentucky Revised Statutes to provide that "'machinery for new and expanded industry' does not include repair, replacement, or spare parts of any kind regardless of whether the purchase of repair, replacement or spare parts is required by the manufacturer or vendor as a condition of sale or as a condition of warranty."¹³⁷ House Bill 455 also amended section 139.170 to provide that "'[r]epair, replacement, or spare parts' does not include machine oils, grease, or industrial tools."¹³⁸ Finally, House Bill 455 amended section 139.470, which exempts, among other things, supplies from sales and use tax. As amended, section 139.470(11)(a)(2) concludes that "[s]upplies [do] not include repair, replacement, or spare parts of any kind."¹³⁹

(2) It must be used directly in the manufacturing process.

(3) It must be incorporated for the first time into plant facilities established in this state.

(4) It must not replace other machinery.

103 KY. ADMIN. REGS. 30:120(1) (1997).

In *Camera Center, Inc. v. Kentucky Revenue Cabinet*, 1997 Ky. Tax LEXIS 1, the Kentucky Board of Tax Appeals held that photographic processing equipment used by a retailer of cameras, film, and other photographic supplies did not qualify as exempt machinery for new and expanded industry because it was not incorporated into the plant facilities in the state for the first time.

¹³⁴ *Kentucky Revenue Cabinet v. Armco, Inc.*, 838 S.W.2d 396 (Ky. Ct. App. 1992).

¹³⁵ *See id.* at 402.

¹³⁶ *See id.*

¹³⁷ 1994 Ky. Acts ch. 501, § 1(1) (codified at K.R.S. § 139.170(1)).

¹³⁸ K.R.S. § 139.170(2)(a).

¹³⁹ Subsection (b) of this section provides:

It shall be noted that in none of the three (3) categories is any exemption provided for repair, replacement, or spare parts. Repair, replacement, or spare parts shall not be considered to be materials, supplies, or industrial tools directly used in manufacturing or industrial processing. Repair, replacement, or spare parts shall have the same meaning as set forth in K.R.S. 139.170.

Id. § 139.470(11)(b).

*I. Taxation of Retirement Income – House Bill 1*¹⁴⁰

In *Davis v. Michigan Department of Treasury*,¹⁴¹ the United States Supreme Court struck down a Michigan statute that imposed state income tax on federal pensioners while exempting state pensioners from that tax.¹⁴² The Court found that the scheme violated the federal constitutional doctrine of intergovernmental tax immunity.¹⁴³ In 1990, the Kentucky legislature amended section 141.021¹⁴⁴ of the Kentucky Revised Statutes to exempt federal retirement benefits from state income tax in order to correct its prior taxing scheme, which, like the Michigan scheme, had exempted state pensioners while taxing federal pensioners.¹⁴⁵

Following the *Davis* decision, federal pensioners in Kentucky filed suit, claiming a refund of taxes they had paid under the pre-1990 scheme.¹⁴⁶ The Revenue Cabinet conceded that the old statutory scheme was invalid, but contested the refund claim by claiming that the decision was not retroactive.¹⁴⁷ In *Kentucky Revenue Cabinet v. Gossum*,¹⁴⁸ the Kentucky Supreme

¹⁴⁰ Enact. Acts 1995, ch. 1 (2d Ex. Sess.) (codified at K.R.S. § 141.010(i)).

¹⁴¹ *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989).

¹⁴² See *id.* at 817.

¹⁴³ For a more detailed discussion of the *Davis* decision, see, for example, HELLERSTEIN & HELLERSTEIN, *STATE TAXATION*, *supra* note 72, ¶ 22.04[3]; Corinna L. Eckl et al., *State Taxation of Public Pensions: The Impact of Davis v. Michigan*, 47 TAX NOTES at 1119 (May 28, 1990).

¹⁴⁴ 1990 Ky. Acts ch. 305, § 1 (codified at K.R.S. § 141.021 (Michie 1991)).

¹⁴⁵ In *Finley v. Kentucky Revenue Cabinet*, 1996 Ky. Tax LEXIS 373, *3 (Ky. Bd. Tax App.), the Kentucky Board of Tax Appeals found that the post-1990 scheme did “not exempt from tax retirement income received from a retirement or pension plan of a state other than the Commonwealth of Kentucky.”

¹⁴⁶ See *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329, 331 (Ky. 1994).

¹⁴⁷ See *id.* For a more detailed discussion of the retroactivity and refund issues, see, for example, Richard H. Fallon, Jr. & Daniel J. Meltzer, *New Law, Non-Retroactivity, and Constitutional Remedies*, 104 HARV. L. REV. 1731 (1991); Eric Rakowski, *Harper and Its Aftermath*, 1 FLA. TAX REV. 445 (1993); David F. Shores, *Recovery of Unconstitutional Taxes: A New Approach*, 12 VA. TAX REV. 167 (1992); Linda K. Webster, *Davis v. Michigan Department of Treasury: The Retroactivity Morass in Refunds of State Taxes*, 138 MIL. L. REV. 127 (1992); Carl D. Ciochon, Note, *Nonretroactivity in Constitutional Tax Refund Cases*, 43 HASTINGS L.J. 419 (1992); see also *Reich v. Collins*, 513 U.S. 106 (1994); *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993); *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529 (1991); *American Trucking Ass'n v. Smith*, 496 U.S. 167 (1990).

¹⁴⁸ *Kentucky Revenue Cabinet v. Gossum*, 887 S.W.2d 329 (Ky. 1994).

Court held that the *Davis* decision applied retroactively¹⁴⁹ and that federal pensioners in Kentucky were entitled to a refund of income taxes paid under Kentucky's similar unconstitutional scheme.¹⁵⁰ The court further held that Kentucky's two-year statute of limitations for refunds of unconstitutional taxes, found in section 134.590 of the Kentucky Revised Statutes, applied, rather than the four-year statute of limitations for refunds of taxes other than ad valorem and unconstitutional taxes found in section 134.580.¹⁵¹ Finally, the court held that the two years began to run from the date the tax involved was paid, rather than from the date the complaint was filed or the decision was finalized.¹⁵²

In *Kentucky Revenue Cabinet v. Cope*,¹⁵³ private pensioners brought a challenge under section 59(15) of the Kentucky Constitution¹⁵⁴ to the post-1990 scheme that exempted the pensions of public sector employees while taxing private pensioners. The court found that the distinction between governmental and private sector employees was not unreasonable or arbitrary, and therefore upheld the statutory scheme.¹⁵⁵

Notwithstanding the court's decision in *Cope*, the Kentucky General Assembly again amended its income taxing scheme in 1995 to equalize

¹⁴⁹ See *id.* at 332 ("Harper is unambiguous in its holding that *Davis* applies retroactively . . .").

¹⁵⁰ See *id.* at 333.

¹⁵¹ See *id.* at 333-35.

¹⁵² See *id.* at 335. The trial court had held that claims must be made within two years from the date the amount due was determined through litigation. See *id.* at 331.

¹⁵³ *Kentucky Revenue Cabinet v. Cope*, 875 S.W.2d 87 (Ky.), *cert. denied*, 513 U.S. 931 (1994).

¹⁵⁴ Section 59(15) prohibits "local or special acts" that are "to authorize or to regulate the levy, the assessment or the collection of taxes, or to give any indulgence or discharge to any assessor or collector of taxes, or to his sureties." The pensioners in *Cope* also challenged the statutory scheme under section 2 of the Kentucky Constitution, but the court quickly dismissed that challenge. See *id.* at 92.

¹⁵⁵ See *id.* at 90. Pointing to the lack of profit motive in the public sector, the restrictions imposed on the government in setting pay, and the lower pay scale of governmental employees, the court noted that the statute would have survived even a more rigorous standard of review. See *id.* at 90-91. For an editorial criticizing the court's decision, see *Injustice on Pensions: Decision Leaves Equal Protection Intact*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Feb. 2, 1994, at A10; see also Jack Brammer & Chad Carlton, *Pension Tax Ruling Saves State Millions*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Feb. 1, 1994, at A1; *Pension Ruling a Slap in the Face, Private-sector Retirees Say*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Feb. 1, 1994, at A6.

prospectively the treatment of pension benefits received by public and private pensioners.¹⁵⁶ It phased in, over a several-year period ending on January 1, 1998, a \$35,000 exclusion, adjusted for inflation,¹⁵⁷ for distributions¹⁵⁸ from pension plans, annuity contracts, profit-sharing plans, retirement plans, and employee savings plans.¹⁵⁹ For state and federal retirees, it grandfathered in the taxation of pension benefits so that pension benefits that exceed the \$35,000 exclusion are taxable only to the extent they are attributable to earnings after January 1, 1998.¹⁶⁰

II. JUDICIAL DEVELOPMENTS

A. *Intangibles Tax*

In *St. Ledger v. Kentucky Revenue Cabinet*,¹⁶¹ the Kentucky Supreme Court addressed challenges to two Kentucky taxing statutes: section 132.030 of the Kentucky Revised Statutes, which taxed out-of-state bank deposits at a higher rate than in-state deposits; and section 136.030(1), which exempted from taxation the stock of corporations that paid taxes to the state on at least seventy-five percent of their total property. The court held that section 132.030 impermissibly discriminated against interstate commerce in violation of the Commerce Clause and thus struck down the taxing statute. With respect to section 136.030(1), however, the court found that despite the fact that it facially discriminated against interstate commerce, it did not violate the Commerce Clause because it was a valid compensating tax under *Darnell v. Indiana*.¹⁶²

¹⁵⁶ See 1995 Ky. Acts ch. 1 (2d Ex. Sess.) (codified at K.R.S. §§ 141.010 & 141.010(5) (Michie Supp. 1996)).

¹⁵⁷ See *id.* at ch. 1, § 10 (2d Ex. Sess.) (codified at K.R.S. § 141.010(5)).

¹⁵⁸ Distributions are defined to include any lump-sum distribution from pension or profit-sharing plans qualifying for the income tax averaging provisions of section 402 of the Internal Revenue Code ("IRC"); any distribution from any individual retirement account as defined in section 408 of the IRC; and any disability pension distribution that is taxed as pension and annuity income for federal income tax purposes. See K.R.S. § 141.010(10)(i)(3)(a).

¹⁵⁹ 1995 Ky. Acts ch. 1, § 1 (2d Ex. Sess.) (adding K.R.S. § 141.010(10)(i)).

¹⁶⁰ See K.R.S. § 141.0215 (Michie Supp. 1996).

¹⁶¹ *St. Ledger v. Kentucky Revenue Cabinet*, 912 S.W.2d 34 (Ky. 1995), *vacated and remanded*, 116 S. Ct. 1821 (1996), *on remand*, 942 S.W.2d 893 (Ky.), *cert. dismissed*, 118 S. Ct. 27 (1997).

¹⁶² *Darnell v. Indiana*, 226 U.S. 390 (1912).

Following the Kentucky Supreme Court's decision in *St. Ledger*, the United States Supreme Court decided *Fulton Corp. v. Faulkner*.¹⁶³ In that case, the Court held that a North Carolina intangibles taxing scheme that was substantially similar to the Kentucky scheme violated the Commerce Clause.¹⁶⁴ In striking down the North Carolina taxing scheme, the Court declared that *Darnell* no longer represented good law under the Commerce Clause.¹⁶⁵

After deciding *Fulton*, the United States Supreme Court vacated and remanded the Kentucky Supreme Court's judgment in *St. Ledger v. Kentucky Revenue Cabinet*¹⁶⁶ in light of *Fulton*.¹⁶⁷ On remand, the Kentucky Supreme Court noted that both parties agreed that section 136.030(1) violated the Commerce Clause in light of *Fulton*.¹⁶⁸ The court then held that section 136.030(1) could not be severed from section 132.020 and that the appellants were entitled to a refund of the unconstitutional taxes paid for two years before filing of their refund applications.¹⁶⁹ The intangibles tax dispute is discussed in more detail in a Note in this issue.¹⁷⁰

B. *Unmined Minerals Tax*

Before 1988, section 132.020(5) of the Kentucky Revised Statutes provided a taxing scheme for unmined coal by classifying it separately from other real property and taxing it at the rate \$.001 per \$100 of assessed value.¹⁷¹ In *Gillis v. Yount*, the Kentucky Supreme Court held that this de facto tax exemption violated section 171 of the Kentucky Constitution, which requires uniformity in property taxation. Following the court's decision, the property valuation administrators in each county began to

¹⁶³ *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

¹⁶⁴ *See id.* at 327. The North Carolina intangibles tax was imposed on "a fraction of the value of corporate stock owned by state residents inversely proportional to the corporation's exposure to the State's income tax." *Id.*

¹⁶⁵ *See id.* at 346.

¹⁶⁶ *St. Ledger v. Kentucky Revenue Cabinet*, 116 S. Ct. 1821 (1996).

¹⁶⁷ *See id.* at 1821.

¹⁶⁸ *See St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893, 896 (1997). The court also let its decision striking down the bank deposit tax stand. *See id.*

¹⁶⁹ *See id.* at 903.

¹⁷⁰ *See Alsip et al., supra* note 2.

¹⁷¹ *See Gillis v. Yount*, 748 S.W.2d 357, 359 (Ky. 1988).

assess unmined coal for property tax purposes.¹⁷² In 1988, the Franklin Circuit Court entered a temporary injunction requiring the Revenue Cabinet to centralize the assessment of unmined coal.¹⁷³ Pursuant to the temporary injunction, the Cabinet decided to adopt and implement a Geographic Information System ("GIS") to assess unmined coal.¹⁷⁴ Because the GIS was very complicated, costly, and time-consuming, the Cabinet adopted an interim method to assess unmined coal for tax years 1989 through 1991.¹⁷⁵

Under the interim method, the Cabinet mailed an information return form to owners of unmined coal, coal operators, lessees, and permit holders.¹⁷⁶ Taxpayers were asked to report on the forms "ownership information, the number of acres of minable and merchantable coal, the average seam thickness, the location of the coal by county, and whether the coal was idle, permitted or permitted and producing."¹⁷⁷ Taxpayers also were asked to provide any additional information that would aid in valuing the coal resource.¹⁷⁸ The Cabinet applied a formula to the information obtained from the returns to value the unmined coal and did not independently survey or inspect any property in making valuations.¹⁷⁹

Owners of tracts of coal filed suit claiming the interim method violated the Kentucky Constitution because it did not consider certain individual characteristics of the property that could affect the property's value.¹⁸⁰ In *Kentucky Revenue Cabinet v. Gillig*, an opinion that has not yet become final,¹⁸¹ the Kentucky Supreme Court upheld the constitutionality of the interim method. The Court held that for tax purposes, a tax assessor is allowed to use mass appraisal techniques to value property.¹⁸² Under the mass appraisal approach, all the individual characteristics of property need not be considered so long as those factors that allow the assessor to make a logical estimate of the property's value are taken into account.¹⁸³ Section

¹⁷² See *Kentucky Revenue Cabinet v. Gillig*, 1997 Ky. LEXIS 91, *1-2 (1997) (decision not final).

¹⁷³ See *id.* at *2.

¹⁷⁴ See *id.*

¹⁷⁵ See *id.* at *2-4.

¹⁷⁶ See *id.* at *2-3.

¹⁷⁷ *Id.* at *3.

¹⁷⁸ See *id.*

¹⁷⁹ See *id.* at *3-4.

¹⁸⁰ See *id.* at *4.

¹⁸¹ See *id.* at *1.

¹⁸² See *id.* at *8.

¹⁸³ See *id.*

172 of the Kentucky Constitution requires that fair cash value be "estimated" and does not require that a tax assessor achieve the level of accuracy of private fee appraisers.¹⁸⁴

C. License Tax

Section 136.070 of the Kentucky Revised Statutes imposes, with specific enumerated exceptions, an annual license tax on "every corporation organized under the laws of this state, every corporation having its commercial domicile in this state, and every foreign corporation owning or leasing property located in this state or having one (1) or more individuals receiving compensation in this state."¹⁸⁵ The license tax is imposed at the rate of \$2.10 on each \$1000 of capital employed in Kentucky,¹⁸⁶ and defines capital as "capital stock, surplus, advances by affiliated companies, intercompany accounts, borrowed moneys or any other accounts representing additional capital used and employed in the business."¹⁸⁷ Section 136.071 permits domestic holding companies to eliminate capital invested in subsidiaries from the calculation of the license tax.¹⁸⁸

In an unpublished opinion that subsequently was withdrawn, the Kentucky Court of Appeals held that USX, a foreign holding company that satisfied the requirements of section 136.071, but for the fact that it was not domiciled in the state, was not entitled to rely on the statute to calculate its license tax liability.¹⁸⁹ Although the trial court had held the preferential tax scheme unconstitutional and the Revenue Cabinet did not appeal that portion of the judgment, the court of appeals held that USX was required to base its license tax liability on the higher section 136.070 calculation rather than the lower section 136.071 liability.¹⁹⁰ "A court may not strike down a statute and then grant a remedy based upon the same statute."¹⁹¹

In 1996, legislation was introduced to extend the favorable tax treatment accorded by section 136.071 to all holding corporations,

¹⁸⁴ See *id.* at *9.

¹⁸⁵ K.R.S. § 136.070(1) (Michie Supp. 1996).

¹⁸⁶ See *id.*

¹⁸⁷ *Id.* § 136.070(2)(a).

¹⁸⁸ See *id.* § 136.071.

¹⁸⁹ See *Kentucky Revenue Cabinet v. USX Corp.*, No. 93-CA-000072-MR and No. 93-CA-000123-MR (Ky. Ct. App. 1994), reprinted in 1995 UPDATE, *supra* note 8, at 122-30.

¹⁹⁰ See *id.* at 125.

¹⁹¹ *Id.*

regardless of their domicile, but the General Assembly did not enact it.¹⁹² USX has since filed a second action challenging the preferential tax treatment afforded by section 136.071.¹⁹³

In *Kroger Co. v. Kentucky Department of Revenue*,¹⁹⁴ the Kentucky Court of Appeals held that a positive balance in a deferred tax liability account was includable as capital for purposes of the license tax because it represented surplus that was available to the corporation for use in its business. Including the positive balance in capital had the effect of increasing capital subject to taxation. In the unpublished and subsequently withdrawn *USX* decision, the court of appeals extended that treatment to a negative balance in a deferred tax liability account because it represented funds that were not available to the corporation for use in its business.¹⁹⁵ Extending inclusion in capital to negative balances in deferred tax accounts had the effect of decreasing total capital subject to taxation. On December 1, 1995, the Kentucky Revenue Cabinet formally adopted the *USX* decision by revising Revenue Policy 41P520 to provide that both receivable and payable balances in intercompany accounts and deferred tax benefits and liabilities qualify as capital for purposes of section 136.070.¹⁹⁶

Finally, in the unpublished and subsequently withdrawn *USX* decision, the Kentucky Court of Appeals held that capital invested in *USX*'s nonunitary subsidiaries was includable in its capital for purposes of the license tax.¹⁹⁷ Relying on *Armco, Inc. v. Kentucky Revenue Cabinet*,¹⁹⁸ which held that capital invested by a corporation in a subsidiary was includable capital for purposes of the license tax,¹⁹⁹ the court rejected *USX*'s claim that the subsidiaries should not be includable in capital because they were nonunitary.²⁰⁰ The court further rejected *USX*'s claim

¹⁹² See Timothy C. Kimmel, *Corporate License Tax and Bank Franchise Tax*, 1997 UPDATE, *supra* note 9, at IV-5.

¹⁹³ See *id.*

¹⁹⁴ *Kroger Co. v. Kentucky Dep't of Revenue*, 614 S.W.2d 705 (Ky. Ct. App. 1981).

¹⁹⁵ See *Kentucky Revenue Cabinet v. USX Corp.*, No. 93-CA-000072-MR and No. 93-CA-000123-MR (Ky. Ct. App. 1994), *reprinted in* 1995 UPDATE, *supra* note 8, at 127-29.

¹⁹⁶ See Revenue Policy 41P520 (Revised Dec. 1, 1995).

¹⁹⁷ See *USX*, No. 93-CA-000072-MR and No. 93-CA-000123-MR, *reprinted in* 1995 UPDATE, *supra* note 8, at 130.

¹⁹⁸ *Armco, Inc. v. Kentucky Revenue Cabinet*, 748 S.W.2d 372 (Ky. 1988).

¹⁹⁹ See *id.* at 376.

²⁰⁰ See *USX*, No. 93-CA-000072-MR and No. 93-CA-000123-MR, *reprinted in* 1995 UPDATE, *supra* note 8, at 130. In *Armco*, the court made no mention of

that the subsidiaries did not add value to USX.²⁰¹ The court declared, "USX may use and invest its capital in many ways, all of which are calculated to bring USX a profit. The investment vehicle chosen by a corporation for its capital does not determine the applicability of the corporate license tax."²⁰²

D. Taxation of Cellular Telephone Companies

In *Central Kentucky Cellular Telephone Co. v. Kentucky Revenue Cabinet*,²⁰³ the Kentucky Court of Appeals held that cellular telephone companies are telephone companies for purposes of section 136.120.²⁰⁴ The court declared that the fact that the cellular telephone companies operate with technology that did not exist when the statute was adopted does not prevent them from qualifying as telephone companies for purposes of the statute.²⁰⁵ Rather, the term "telephone company" for purposes of the statute is to be construed according to its general and common usage, and cellular telephone companies are commonly understood to be telephone companies.²⁰⁶ Thus, cellular telephone companies are subject to state taxation on their operating property pursuant to section 136.120.²⁰⁷

whether the subsidiaries were part of the company's unitary business. *See Armco, Inc.*, 748 S.W.2d at 376. In discussing whether Armco had to include its domestic international sales corporation ("DISC") income for purposes of income taxation, however, the court noted that Armco and its DISC operated a unitary business. *See id.* at 375. For a more detailed discussion of this issue, see *supra* notes 33-40 and accompanying text.

²⁰¹ *See USX*, No. 93-CA-000072-MR and No. 93-CA-000123-MR, *reprinted in* 1995 UPDATE, *supra* note 8, at 130.

²⁰² *Id.*

²⁰³ *Central Kentucky Cellular Tel. Co. v. Kentucky Revenue Cabinet*, 897 S.W.2d 601 (Ky. Ct. App. 1995).

²⁰⁴ *See id.* at 603. Section 136.120(1) lists several public service corporations, including telephone companies, and requires that each of the listed corporations "annually pay a tax on its operating property to the state and to the extent the property is liable to taxation shall pay a local tax thereon to the county, incorporated city, and taxing district in which its operating property is located." *See id.* (quoting K.R.S. § 136.120(1)).

²⁰⁵ *See id.*

²⁰⁶ *See id.*

²⁰⁷ *See id.*

E. Apportionment Formula

Kentucky, like most states that have a broad-based corporate income tax,²⁰⁸ uses a three-factor apportionment formula²⁰⁹ to apportion or divide the taxpayer's business income²¹⁰ among the states where it does business.²¹¹ Specifically, Kentucky apportions the taxpayer's income to the state based on the percentage of its property, sales, and payroll attributable to the state.²¹²

Like all states that have a broad-based corporate income tax,²¹³ Kentucky uses a destination rule to attribute sales to the state in which the goods are shipped to the customer or to the state in which they are

²⁰⁸ See 1 State Tax Guide (CCH) ¶ 10-110, at 2582-83 (1997) (listing the apportionment formulas in each state).

²⁰⁹ See K.R.S. § 141.120(8).

²¹⁰ Section 141.120(1)(a) defines business income as "income arising from transactions and activity in the regular course of a trade or business of the corporation and includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes integral parts of the corporation's regular trade or business operations." *Id.* § 144.120(1)(a). For a discussion of the varying ways in which this language may be interpreted, see Harriet Hanlon, *Fairness, Simplification, Business Income, Open Meetings Highlighted at MTC*, 11 STATE TAX NOTES 474, 466-77 (1996) (describing four interpretations of the business income definition in the Uniform Division of Income for Tax Purposes Act ("UDITPA")).

²¹¹ Formula apportionment proceeds from the theory that certain factors or elements "measure the income creating activities of the corporation in a particular taxing jurisdiction." Arthur D. Lynn, Jr., *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 OHIO ST. L.J. 84, 89 (1957); see also JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 410 (6th ed. 1997) [hereinafter HELLERSTEIN & HELLERSTEIN, STATE AND LOCAL TAXATION]. For a more detailed discussion of apportionment formula, see, for example, Symposium, *State Taxation of Interstate Commerce*, 27 TENN. L. REV. 239, 251-57 (1960); Donald K. Barnes, *Prerequisites of a Federal Statute Regulating State Taxation of Interstate Commerce*, 46 VA. L. REV. 1269, 1276-82 (1960).

²¹² See K.R.S. § 141.120(8). Kentucky's apportionment formula gives double weight to the sales factor. See *id.* Thus, if a corporation has 15% of its sales, 35% of its property, and 40% of its payroll attributable to Kentucky, then 26% (or $[15 + 15 + 35 + 40] / 4$) of its income will be apportioned to the state under Kentucky's apportionment formula.

²¹³ See 1 State Tax Guide (CCH) ¶ 10-110, at 2584-85 (1997) (listing each state's position on the destination test).

delivered to the customer.²¹⁴ Specifically, section 141.120(8)(c)(2)(a) provides that sales of tangible personal property are attributable to the state if “[t]he property is delivered or shipped to a purchaser, other than the United States government, or to the designee of the purchaser within this state regardless of the f.o.b. point or other conditions of the sale.”²¹⁵

There are three justifications for this destination rule. First, it balances against the property and payroll factors. “To localize sales in the state from which the goods are shipped would, in many instances, duplicate the property and payroll factors.”²¹⁶ Second, attributing sales to the destination state recognizes the consumer state’s role in the production of income. Finally, allocating sales to the destination state is easy to administer.²¹⁷

In *Kentucky Revenue Cabinet v. Rohm and Haas Kentucky, Inc.*,²¹⁸ the court addressed the question of whether products sold to a nonresident parent that are picked up at the taxpayer’s dock in Kentucky in the parent’s trucks and shipped to customers and locations outside of Kentucky are attributable to Kentucky under section 141.120(8)(c).²¹⁹ Following the lead of all other state courts that have interpreted similar language,²²⁰ the court held that the words “within this state” modify the word “purchaser” rather than the word “delivered,” and thus the sales were attributable to the state of their ultimate destination rather than their state of delivery, Kentucky.²²¹

Like most states that have a broad-based corporate income tax,²²² Kentucky has a “throwback rule” that throws back to the state of origin

²¹⁴ See K.R.S. § 141.120(8)(c)(2).

²¹⁵ *Id.* § 141.120(8)(c)(2)(a).

²¹⁶ Symposium, *supra* note 211, at 256.

²¹⁷ See *id.*; see also Lynn, *supra* note 211, at 50-51.

²¹⁸ *Kentucky Revenue Cabinet v. Rohm & Haas Ky., Inc.*, 929 S.W.2d 741 (Ky. Ct. App. 1996).

²¹⁹ See *id.* at 742.

²²⁰ This statutory language comes almost verbatim from the UDITPA. See *id.* at 742-43.

²²¹ See *id.* at 743-45. Jerome and Walter Hellerstein note that the Multistate Tax Commission regulations and the New York franchise tax regulations take a contrary position and contend that whether dock sales to out-of-state purchasers should be attributed to the ultimate destination or the place of delivery is a close question. See HELLERSTEIN & HELLERSTEIN, STATE AND LOCAL TAXATION, *supra* note 211, at 619-21.

²²² See 1 State Tax Guide (CCH) ¶ 10-110, at 2584-85 (1997) (listing each state’s position on the throwback rule).

sales to the United States government.²²³ Section 141.120(8)(c)(2)(b) provides that sales of tangible personal property are attributable to the state if “[t]he property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the purchaser is the United States government.”²²⁴ The principal purpose for this throwback rule is that the place of delivery in the case of sales to the United States government may be entirely casual and may not be related in any way to the business activity conducted in the state.²²⁵ Sales to the United States government are frequently made to a single large purchasing facility and subsequently shipped throughout the United States for consumption. It would be unfair to have sales attributed to the state of delivery when the goods would not necessarily be consumed in that state.²²⁶

In *Jim Beam Brands Co. v. Kentucky Revenue Cabinet*,²²⁷ the Kentucky Board of Tax Appeals held that sales of distilled spirits to overseas military clubs did not constitute sales to the United States government within the meaning of section 141.120(8)(c)(2).²²⁸ The sales in that case were ordered by and delivered to specific military clubs, where the whiskey was consumed by third parties.²²⁹ Once shipped out of the United States, the distilled spirits could only go to the military clubs that ordered them and could not be diverted to any other location.²³⁰ The Board found that the reason for the government throwback rule did not apply, so the throwback rule should not apply.²³¹ The destination of the sales was not entirely

²²³ See K.R.S. § 141.120(8)(c)(2)(b) (Michie Supp. 1996).

²²⁴ *Id.*

²²⁵ See Symposium, *supra* note 211, at 256; see also Lynn, *supra* note 211, at 50-51; UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT § 16 cmt., 7A U.L.A. 354 (1985) (holding “sales to the United States government are treated separately because they are not necessarily attributable to a market existing in the state to which the goods are originally shipped”).

²²⁶ See Kimmel, *Corporate Income Tax*, 1997 UPDATE, *supra* note 9, at III-4.

²²⁷ *Jim Beam Brands Co. v. Kentucky Revenue Cabinet*, 1993 Ky. Tax LEXIS 185 (Ky. Bd. Tax App., July 28, 1993).

²²⁸ See *id.* at *7.

²²⁹ See *id.* at *2.

²³⁰ See *id.* at *2-3.

²³¹ See *id.* at *5 (“The United States throwback rule was intended in part to prevent the normal destination rules of K.R.S. 141.120(8)(c) from being manipulated. Sales by Beam to overseas military installations are not capable of such manipulation.”).

fortuitous but instead was directly related to activity conducted at the destination.

F. Use Taxation of Newspaper Preprints

Section 139.310 imposes a use tax on the storage, use, or other consumption in this state of personal property purchased for storage, use, or other consumption in the state.²³² For approximately thirty years, the Kentucky Revenue Cabinet did not assess a use tax on advertising preprints²³³ purchased from out-of-state printers and shipped to Kentucky newspaper publishers for insertion in and distribution with newspapers. Then, in audits beginning in 1990, the Kentucky Revenue Cabinet began to assess use taxes on advertising preprints.²³⁴

In two recent cases,²³⁵ the Board of Tax Appeals held that the Revenue Cabinet was prevented from assessing a use tax on advertising preprints purchased outside of the state and distributed in Kentucky newspapers because it had a long-standing practice of not imposing a use tax on such transactions.²³⁶ The Board's opinions, however, were not entirely clear as to whether the policy could be changed simply by an administrative regulation promulgated by the Revenue Cabinet pursuant to the

²³² See K.R.S. § 139.310 (Michie 1991).

²³³ "Preprints are newspaper supplements prepared for businesses by third-party printers pursuant to contracts between the printer and the business." *Dayton Hudson Corp. v. Kentucky Revenue Cabinet*, 1997 Ky. Tax LEXIS 203, at *2 (Ky. Bd. Tax App., May 14, 1997).

²³⁴ See *id.* at *6.

²³⁵ See *id.*; *Lazarus, Inc. v. Kentucky Revenue Cabinet*, 1997 Ky. Tax LEXIS 338 (Ky. Bd. Tax App., Aug. 20, 1997).

²³⁶ See *Lazarus, Inc.*, 1997 Ky. Tax LEXIS 338, at *1; *Dayton Hudson Corp.*, 1997 Ky. Tax LEXIS 203, at *6-7. The Kentucky Board of Tax Appeals applied similar reasoning in *Humana, Inc. v. Kentucky Revenue Cabinet*, 1996 Ky. Tax LEXIS 552 (Ky. Bd. Tax App., Mar. 11, 1996), to prohibit the Revenue Cabinet from assessing sales and use taxes on prescription medicine and prosthetic devices and physical aids purchased by five health care companies. In that case, the Revenue Cabinet announced in correspondence with the companies and in a circular letter the change in its 18-year-old policy. See *id.* at *2-3.

procedures provided in section 13A²³⁷ or only be a legislative amendment.²³⁸

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This Board concludes that the Cabinet's position that newspaper preprints are subject to use tax is a 'statement of general applicability . . . that implements, interprets or prescribes law or policy' and therefore is properly the subject of an administrative regulation. KRS 13A.010(2). KRS 13A.130 prohibits an administrative body from modifying, expanding upon, or limiting a statute by internal policy, memorandum, or other form of action, and declares any such action to be null, void, and unenforceable. Because the Cabinet did not follow the mandatory KRS 13A procedures governing the promulgation of administrative regulations but instead proceeded to change its policy concerning the assessment of use tax on newspaper preprints, this Board concludes that the Cabinet's policy change is null, void, and unenforceable pursuant to KRS 13A.130.

Dayton Hudson Corp., 1997 Ky. Tax LEXIS, at *6-7.

In *Lazarus, Inc.*, the Board provided:

To the extent the Revenue Cabinet has the authority to interpret the Kentucky sales and use tax statutes to require a use tax assessment against newspaper supplements, that authority must be exercised in the form of a duly promulgated and adopted administrative regulation. The Revenue Cabinet made no effort to comply with KRS Chapter 13A in this case and is therefore precluded from assessing use tax against newspaper preprints.

Lazarus, Inc., 1997 Ky. Tax LEXIS 321, at *6 (emphasis added).

²³⁸ See *Dayton Hudson Corp.*, 1997 Ky. Tax LEXIS, at *6 ("Because the Cabinet did not previously assess a use tax against Target for newspaper preprints, it cannot now be permitted to impose a use tax on Target without statutory authority."). The Board noted in *Lazarus, Inc.*:

Because the Revenue Cabinet routinely and consistently treated preprinted supplements as part of the newspaper and/or found them not subject to use tax because they were not used, stored, or consumed in Kentucky, the Revenue Cabinet is precluded from abandoning that long-standing interpretation without specific statutory authority.

Lazarus, Inc., 1997 Ky. Tax LEXIS 321, at *6.